on a forward-looking cost basis, the Act reduces economic barriers to entry that might otherwise have existed. When combined with meeting the checklist, these requirements create open entry conditions that provide a strong assurance that BOCs will not engage in anticompetitive activity.

14. Under the Act, it is the conditions for open entry, rather than entry itself or achievement of any specified level of competition, that are most important in terms of determining whether an incumbent LEC will be able to engage in anticompetitive behavior. Economic theory recognizes, and empirical evidence confirms, the disciplining effect of open entry conditions. For example, when considering how to appropriately measure market power, the Merger Guidelines of the Department of Justice and Federal Trade Commission consider two effects. First, an analysis of the relevant market must include

> "other firms not currently producing or selling the relevant product in the relevant area [are treated] as participating in the relevant market if their inclusion would more accurately reflect probable supply responses."[5]

Such firms must be likely to enter profitably within one year in response to a small but significant margin between market price and cost and without any expenditure of significant sunk costs of entry. Second, over a longer period, the Guidelines consider

> "the timeliness, likelihood, and sufficiency of the means of entry...a potential entrant might practically employ."[6]

The Commission correctly noted that "[t]he more vigorous the competition is in the BOC's local market, the greater is the assurance that the BOC is cooperating in opening its market to competition and that entry through the various methods set forth in section 251(c) of the 1996 Act is possible,"[7] but also has signaled that the lack of broad-based competition would not preclude a favorable ruling on a section 271 entry petition as long as the BOC can demonstrate

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[5] The U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, April 2, 1992, § 1.32 at 20-21.

[6] Ibid., § 3, at 50.

[7] Michigan Order, ¶ 402.

"that it is ready, willing, and able to provide each type of interconnection arrangement on a commercial scale throughout the state if requested."[8] which is tantamount to a demonstration of open entry conditions.

15. In addition to specifying conditions that must be met with respect to interconnection, the Act also requires the BOCs to establish structurally-separate affiliates (i.e., separate from the local exchange carrier operating companies), for at least three years, for the provision of interLATA services. Both the FCC and the Oklahoma Corporation Commission (OCC) have significant experience since divestiture with regulating affiliate transactions in order to prevent anti-competitive behavior and subsidization. The FCC has already concluded that its existing affiliate transaction rules (with some minor modifications) are sufficient for implementing the Act.[9] State regulatory commissions, including the OCC, have had significant experience with affiliate transactions of the Bell Operating Companies.

16. Although they will for a time cause Southwestern Bell and its customers to forego some of the potential economies of scope and scale, the Act's separate affiliate requirements (particularly as interpreted by the FCC in its recent order in CC Docket No. 96-149) will give extra protection to interLATA competition by requiring the otherwise integrated BOC to conduct operations and bookkeeping separately for the local exchange carrier and the new interLATA affiliate. This requirement establishes a barrier between the BOCs' provision of services similar to that which currently exists between the BOCs' local exchange carriers and their cellular affiliates, and simplifies the regulators' task. In all my years as a state regulator, there was not one instance of the non-BOC cellular license holder arguing that the BOC discriminated in favor of its cellular affiliate. Note that demand for cellular service grew from

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[8] Michigan Order, ¶ 392.

[9] "The Order also adopts the tentative conclusion in the *NPRM* that our current affiliate transactions rules generally satisfy the Act's accounting safeguards requirements when incumbent local exchange carriers, including the BOCs, are required to, or choose to, use an affiliate to provide services permitted under sections 260 and 271 through 276. The Order adopts most of the *NPRM*'s proposed modifications to the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services." FCC 96-490, Report and Order, CC Docket No. 96-50, ¶ 1.

just over 1.2 million subscribers in 1987 to more than 24 million subscribers at the end of 1994, and cellular service revenues grew in that same period from just over one billion dollars to over 14 billion dollars.[10] Given such growth, what better, more profitable, place could there have been for a BOC to have discriminated in favor of its own affiliate than cellular, yet such discrimination was not alleged *even once* in the time that I was a state regulator. I see no reason to expect that the separate affiliate rules in the Act for BOC interLATA service will not have the same success.

17. The Act also contains a comprehensive set of audit and non-discrimination requirements, some of which must be maintained even after the separate affiliate requirement sunsets.[11] In terms of the auditing provisions, Southwestern Bell will be required to submit to detailed audits in order to ensure that they are complying with the Act's affiliate transaction rules and with the Commission's accounting safeguards. Thus, in addition to the continuing oversight of federal and Oklahoma regulators and competitors, the Act adds an independent auditor to the list of those who will be monitoring Southwestern Bell's activity to ensure that there will be fair competition in the interLATA market. The National Association of Regulatory Utility Commissioners has already prepared audit guidelines for implementation of this provision and has adopted a resolution in support of those guidelines.[12]

18. The antidiscrimination regulations in section 272(e) will work to protect competition in the interLATA market by requiring that SWBT provide local access to all interLATA carriers, including itself or its affiliate, at exactly the same rates, terms, and conditions. While this is not a new concept for regulators to enforce because it is tantamount to the existing requirements of common carriage, its application here reinforces the ability of regulators to protect interLATA competition.

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[10] 1995 Statistical Abstract of the United States, 115th Edition, page 575, Table No. 905.

[11] The Act "sunsets" the separate affiliate requirement for BOC manufacturing and long distance after three years, unless the Commission extends the affiliate requirement by rule or order. Act, § 272(f)(1).

V. SOUTHWESTERN BELL'S COMPLIANCE WITH THE ACT'S REQUIREMENTS

19. As Congress recognized—and the 8th Circuit Court of Appeals confirmed—state regulators are capable of interpreting the Act's interconnection requirements and implementing them for the promotion of open competitive markets, and the OCC has done so in this case. For example, the OCC on December 12, 1996 approved an arbitrated interconnection agreement between SWBT and AT&T.[13] Second, the decisions made by the OCC are generally similar to the Commission's own findings. For example, in the SWBT/AT&T decision, the OCC adopted a 19.8% wholesale discount, which is within the range established by the FCC.[14]

VI. THE PUBLIC INTEREST STANDARD

20. Once compliance with the Act's specific requirements has been demonstrated, the only remaining question for the Commission in ruling on this petition relates to whether interLATA entry is in the public interest. This standard requires the Commission to find that "the requested authorization is consistent with the public interest, convenience, and necessity." Act, § 271(d)(3)(C). This public interest standard is best understood as a straightforward proceeding to evaluate whether the benefits to the public of Southwestern Bell's interLATA entry outweigh any possible risks associated with such entry. The Commission has stated that it will make a case-by-case determination of the public interest weighing a number of factors.[15] The clear focus of this inquiry should be on the interLATA marketplace in Oklahoma.

(...continued)

[12] "Resolution to Support the Attached Audit Guidelines and Analysis to Comply with the Current Federal Legislation to Prevent Cross Subsidization," adopted at the 1996 NARUC Summer Committee Meeting, Los Angeles, CA.

[13] Order No. 407704, Application of AT&T Communications of the Southwest, Inc., for Compulsory Arbitration of Unresolved Issues with Southwestern Bell Telephone Company pursuant to § 252(b) of the Telecommunications Act of 1996, Order Regarding Unresolved Issues, December 12, 1996.

[14] Id., Report and Recommendations of the Arbitrator, p. 19.

[15] FCC 97-298, Memorandum Opinion And Order, In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Michigan, CC Docket No. 97-137, released August 19, 1997 (Michigan Order), ¶ 391.

21. First, it must be recalled that in the Act, Congress has declared that open entry into all telecommunications markets is in the public interest. That fundamental policy choice has been made and is no longer at issue. The FCC has acknowledged that the central purpose of the Act is to "bring to consumers of telecommunications services in all markets the full benefits of vigorous competition." See FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶ 7. Therefore, the public interest generally is served by the participation of willing companies, particularly experienced companies like Southwestern Bell who have demonstrated expertise in the provision of telephone service, in all telecommunications markets. The only way that maintaining a barrier to their entry into long distance could be in the public interest is if their participation is likely to have a negative impact on competition that exceeds the benefits it brings to the market. This inquiry should rely upon practical experience, not just theory or speculation. The evidence of actual competition in the intraLATA toll and cellular markets, where SWBT already provides essential inputs, and where no problems have arisen, strongly indicates that existing regulation, coupled with the new requirements and regulatory tools in the Act, is sufficient to ensure that competition in the interLATA market will not be harmed by participation by the BOCs.

22. The issue of whether or not the Commission is legally allowed to make BOC compliance with its national pricing rules and other related requirements a prerequisite for approval of a 271 petition is currently in litigation. Without speaking to the legal question of the Commission's authority, I would caution the current Commission from a policy standpoint about attempts to reintroduce its pricing rules through the checklist or the public interest test. The interconnection and pricing requirements of sections 251/252 and 271 are virtually the same. Applying different regulatory standards based on jurisdictional disputes to compliance with these requirements has the potential to create serious uncertainty and confusion among regulators, BOCs, and CLECs, and this uncertainty and confusion in turn are likely to delay the introduction and development of efficient competitive markets. This Commission should not succumb to the hubristic belief that its pricing rules are the "one true path" to competition. The states' decisions on compliance with the section 251/252 requirements (which are subject

to review for consistency with the Act in federal district court) should serve as the basis for the Commission's determination of compliance with the same issues in the section 271 checklist.

A. The Benefits of Entry

22. No one can presume to predict exactly what shape the benefits of BOC entry in the interLATA market will take. But it is likely, based on our knowledge of the previous protected markets that have been opened to competition, that these benefits will take the form of price reductions, new marketing programs, bundled service offerings, better customer service, and innovative new or improved services. Only the competitive process itself can determine the specific elements of service that each provider offers or the unique efficiencies that each provider brings to the marketplace. Nevertheless, I have seen evidence strongly suggesting that BOC entry into the interLATA market could result in significant price decreases in current interLATA rates.[16] Given this, it is difficult to conceive that the addition of SBLD to a telecommunications market that is currently dominated by only three large, facilities-based carriers, will not bring significant benefits to consumers. In particular, I expect SBLD's entry to benefit residential, low-volume interLATA customers, who still, over ten years after the break-up of AT&T, have not benefited from existing interLATA competition to the extent that higher-volume customers have. The Commission itself has stated concern "about the relative lack of competition among carriers to serve low volume long distance customers," and its expectation "that BOCs entering the long distance market will compete vigorously for all segments of the market, including low volume long distance customers."[17] Low volume customers have not had access to the volume-based discount plans offered by the incumbent IXCs, and their rates in fact have even been increased several times in the last few years. Evidence from markets where ILECs currently offer interLATA services strongly

[16] Paul W. MacAvoy, The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services (The MIT Press and The AEI Press) 1996, pp. 179-183,

[17] Michigan Order, ¶ 16.

suggests that SBLD's entry will extend the benefits of competition to these low-volume customers:

- Under exceptions to the MFJ, Bell Atlantic competes with interexchange carriers in the New Jersey - New York and New Jersey - Philadelphia "corridors." As of July 1995, Bell Atlantic's basic rates were 20 to 30 percent lower than those of the three largest IXCs.[18]

- As of July 22, 1996, SNET's prices for non-discount customers in Connecticut were 29.8 percent lower than AT&T's prices. Across all customers, SNET's prices were about 22 percent lower.[19]

23. First, competition clearly is not yet as expansive as it could be in the interLATA market. Thirteen years after divestiture, the "Big 3" carriers (AT&T, MCI, and Sprint) still control about 90% of the market between them, and often appear to be raising their prices in lock-step.[20] Only recently has another carrier, WorldCom, begun to approach the scope and size of the smallest of the three carriers.[21] It also seems quite likely that there is room for price reductions in current long-distance rates.[22] In fact, in its decision denying Ameritech's petition for authority to offer interLATA services in Michigan, the Commission has already found that "BOC entry into the long distance market will further Congress' objectives of promoting

[18] "Bell Atlantic Seeks Nondominant Status in 'Corridor'," *Telecommunications Reports*, July 17, 1995.

[19] Hausman, Jerry, Hearing "Economic Forum: Antitrust And Economic Issues" held at July 23, 1996 at the FCC, pp. 69-70.

[20] MacAvoy (1996), p. 83. "By the end of 1993 AT&T had 65 percent, while MCI and Sprint together had 29 percent of interLATA service revenues."

[21] WorldCom and MCI recently announced an agreement for WorldCom to buy MCI for approximately $37 billion in WorldCom stock (cite), which will make MCI WorldCom the second-largest carrier with an estimated 25% market share but will reduce the number of large carriers back to three.

[22] Kenneth Gordon, Alfred E. Kahn, and William E. Taylor, "Economic Competition in Local Exchange Markets," (1996). "AT&T's reported revenue per minute averaged 18 cents in 1994, when its reported carrier access payments averaged 6 cents per (conversation) minute. Incremental toll costs are estimated at 1 - 2 cents per minute and carrier access incremental costs have been estimated at roughly half that level (per conversation minute)." (footnotes omitted).

competition and deregulation of telecommunication markets."[23] The Commission also stated, "We believe that BOC entry into that market could further long distance competition and benefit consumers."[24]

24. Second, Southwestern Bell has substantial experience as a telephone company particularly familiar with customers and their needs in the Oklahoma marketplace, and, therefore, is likely to be an active and effective competitor in the Oklahoma interLATA market on the basis of price, quality, customer service, and reliability. Just as AT&T, MCI, and Sprint have proven to be effective in Internet services, voice messaging, wireless, and other communications-intensive markets outside their traditional sphere of long-distance, Southwestern Bell should be able to make use of what it has learned in the local exchange and intraLATA toll business, with regard to marketing and administrative services, to make it an extremely effective competitor in the Oklahoma interLATA market, even while the Act's separate subsidiary requirement still is in effect. A wider range of economies of scope and scale can likely be used by SBLD to end the "follow the leader" pattern of rate increases, which have prevailed in the interLATA marketplace almost ever since divestiture.

25. Third, Southwestern Bell should be able to take advantage of any economies of scale and scope that it may have "from the LEC up" (*i.e.*, while SWBT and SBLD are prohibited from using any integrative efficiencies in their own operations, they can use those efficiencies derived from sharing a parent corporation), in order to lower rates for customers. The type of efficiencies that Southwestern Bell will be able to take advantage of generally fall under the heading of administrative and support services. In fact, the FCC recently has found that such efficiencies should be allowed for the BOCs.[25] There may be still other economies of

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[23] FCC 97-298, Memorandum Opinion And Order, In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services In Michigan, CC Docket No. 97-137, released August 19, 1997, ¶ 381.

[24] Id., ¶ 388.

[25] "Based on the record before us, we decline to prohibit the sharing of services other than operating, installation, and maintenance services, ... We find that, if we were to prohibit the sharing of services, other than those restricted pursuant to section 272(b)(1), a BOC and a section 272 affiliate would be unable to achieve the (continued...)

scope and scale in terms of the services provided to both the local exchange carrier and interLATA affiliate by the BOC parent corporation, as well, such as general corporate overhead and joint marketing opportunities. In fact, the FCC recognized the potential for such economies when it noted that a goal of its proceeding to implement accounting safeguards for BOC provision of interLATA service was to "preserv[e] for the benefit of interstate telephone ratepayers legitimate economies of scope that could be realized by BOCs and other incumbent local exchange carriers when entering markets from which they were previously barred or in which they continue to participate." See FCC 96-490, Report and Order, CC Docket No. 96-150, ¶ 13.

26. Finally, customers are increasingly demanding "one-stop" shopping for communications services. The Commission itself has recognized that "[a]s firms expand the scope of their existing operations to new product lines, they will increasingly offer consumers the ability to purchase local, intraLATA, and interLATA telecommunications services, as well as wireless, information, and other services, from a single provider ..., and other advantages of vertical integration." See FCC 96-489, Report and Order, CC Docket No. 96-149, ¶ 7.[26] The Commission also stated that "BOCs and other firms, most notably existing interexchange carriers, will be able to offer a widely recognized brand name that is associated with telecommunications services." Id. Surveys have shown that many customers want to buy a full range of communications services from one company and pay for it on one bill.[27] MCI already has begun to heavily market a bundled service package called "MCI One," with the motto "One

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economies of scale and scope inherent in offering an array of services." FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶ 178-183.

The Commission also recently noted that efficiencies derived from the merger of SBC and Pacific Telesis may make the long distance market "somewhat more competitive and efficient." Applications of Pacific Telesis Group and SBC Communications, Inc., FCC No. 97-28, ¶ 74 (rel. January 31, 1997).

[26] See, also, Applications of Pacific Telesis Group and SBC Communications Inc., FCC No. 97-28, ¶ 48 (rel. January 31, 1997). "[T]he bundling of local access and long distance services -- a form of one-stop shopping -- may be a desirable feature for some customers" (footnote omitted).

company, one number, one box, one bill. It's that simple."[28] AT&T also has announced its own package of services called "AT&T.ALL."[29] The desire to provide one-stop shopping is also seen as a driving force behind some recent mergers of competitors to the BOCs.[30]

27. In Oklahoma, SBLD will be an effective competitor of AT&T, MCI, and other companies, who are already offering such packages, to match or better those companies' service offerings and marketing. The fact that AT&T and MCI, well established companies with significant brand recognition, have a clear head start in making bundled offerings, coupled with state and federal regulations, means SBLD would have no unfair marketing advantage in offering "one-stop shopping," for which it would begin with zero market share.

B. The Alleged Risks of Entry

28. Having spent eight years in the Commission as an industry economist, and seven more years as the Chairman of two state public utility commissions, I can attest that the expertise of regulators in ensuring fair competition is far superior to what it was at the time of divestiture. Throughout most of the period of traditional regulation, monopoly structure was

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(...continued)

[27] A recent J.D. Power study found that two thirds of all consumers surveyed said they would prefer to buy all service from their interexchange service company. Communications Daily, 9/5/96, p. 4.

[28] MCI indicates in its advertising that "[o]nly MCI One offers you all of today's communications options - calling, cellular, paging, Internet, and e-mail - and wraps them together in one convenient package." http://www.mci.com/mcione/indexabout.shtml (November 5, 1996).

[29] "Following MCI's lead, AT&T launched a new service to provide business customers with a one-stop shop. The service, called AT&T.ALL, provides features such as one-stop customer care and consolidated billing to businesses subscribing to AT&T long distance and a wide array of AT&T services and calling plans." "AT&T Joins Full-Service Trend," X-Change, November 1996, page 29.

[30] "The big fight for long-distance customers in the U.S. has largely given way to a battle by carriers over which will be the first to offer a bundle of local, long-distance, wireless and Internet services all on the same bill." John J. Keller "BT-MCI Merger Reshapes Telecom Industry," Wall Street Journal, November 5, 1996, page B1.

"This [merger] will make the new firm, MFS WorldCom, the first American telephone company since AT&T's breakup in 1984 to offer customers every sort of telephony: local, long-distance and (since this is 1996) Internet access. One-stop shops are said to represent the future of the telecoms business." "Two Davids Join," The Economist, Vol. 340, No. 7981, August 31, 1996

presumed: there was no occasion to make use of pro-competitive tools. Such is no longer the case, and has not been for some time. Since divestiture, regulators have become adept at using price regulation, imputation requirements, audits, competitive price analyses, and other tools to ensure that incumbent telephone companies do not use their monopoly control of essential access facilities to anticompetitive effect in competitive retail markets. The Commission itself since divestiture has augmented its economic expertise (as opposed to other regulatory skills, such as accounting and engineering), and has even changed the name of its Tariff Division in the Common Carrier Bureau to the Competitive Pricing Division. Even without taking into account any of the new regulatory safeguards in the Act, state and federal regulators are capable of preventing anticompetitive BOC activity in the interLATA market using their existing (i.e., pre-Act) regulatory tools and expertise.

29. The FCC has identified the two ways in which monopoly control of essential local exchange facilities might, in theory, be used to harm competition in the interLATA market: (1) anticompetitive misallocation of costs; and (2) LEC discrimination in favor of the BOC affiliate's interLATA services (see FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶¶ 10-11). Neither one is at all likely to be a problem in the current market and regulatory environment.

1. Misallocation of costs

30. It is worth reviewing how regulators use existing regulatory tools and processes to control the allocation of costs. For example, the Commission currently uses weighted dial equipment minutes to allocate a higher proportion of small telephone companies' local loop costs than would be justified solely by cost considerations to the interstate jurisdiction, in order to help keep basic local service rates low for the customers of these companies. Such an allocation may, in fact, play a role in preventing competition for those customers' basic local service because potential competitors will find it difficult or impossible to compete with a subsidized price, but it is not an "anticompetitive" misallocation in the sense identified by the Commission as a concern. In terms of concerns related to BOC service in competitive markets, anticompetitive misallocation of costs should be understood to mean the assignment by the firm

to monopoly services of costs that are properly attributable to the provision of a competitive service. Precisely because regulators have experience with consciously and purposefully using the allocation of costs for social purposes, they are likely to be more adept at recognizing anticompetitive pricing. Regulators' intimate experience with, and knowledge of, cost accounting mechanisms for ratesetting has prepared them well to identify circumstances where prices are set below incremental cost.

31. The Commission has noted that if a BOC is regulated under rate-of-return regulation, a price caps structure with sharing, a price cap scheme that adjusts its components according to actual changes in industry productivity, or if its revenue recovery is based on costs recorded in regulated books of account, that BOC may have an incentive to allocate costs associated with its interLATA service to its core regulated business (see FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶ 10). These are well understood problems of traditionally regulated settings. SWBT's interstate services are regulated by the FCC under a price cap with no earnings sharing, but SWBT is still regulated in the intraLATA market in Oklahoma under rate-of-return regulation. However, the FCC has noted several times in recent Orders that its existing rules, as modified to conform with the new Act, are sufficient to prevent subsidization and misallocation of costs:

> Our cost allocation and affiliate transactions rules, in combination with audits, tariff review, and the complaint process, have proven successful at protecting regulated ratepayers from bearing the risks and costs of incumbent local exchange carriers' competitive ventures. FCC 96-490, Report and Order, CC Docket No. 96-150, ¶ 25.
>
> In agreement with most commenters, we adopt our tentative conclusion that, except where the 1996 Act imposes specific additional requirements, our current affiliate transactions rules generally satisfy the statute's requirement of safeguards to ensure that these services are not subsidized by subscribers to regulated telecommunications services. We have previously concluded that these rules provide effective safeguards against cross-subsidization. Id., ¶ 108.
>
> We conclude that the accounting safeguards that we adopt in this Order with respect to sections 260 and 271 through 276 are sufficient to implement section 254(k)'s requirement that carriers not "use services that are not

> competitive to subsidize services that are subject to competition." Our existing accounting safeguards, with the modifications that we adopt in this Order, prevent subsidization of competitive nonregulated services, such as those addressed in Sections 260 and 271 through 276 by subscribers to an incumbent local exchange carrier's regulated telecommunications services. Id., ¶ 275.

32. The Commission has concluded that the requirements in the Act, supplemented by its findings in the 130 page Order implementing accounting safeguards, are sufficient to prevent cross-subsidization and misallocation of costs, even where an incentive to misallocate costs exists. It should now be prepared to rely on these safeguards. The Oklahoma Commission also has recently adopted parallel regulations prohibiting subsidization of competitive services and establishing imputation standards.[31]

33. Another argument advanced by the incumbent IXCs is that, as long as BOC switched access service is priced above incremental cost, there is a non-traditional price squeeze that BOCs can apply to unaffiliated competitors in the interLATA market (see Franklin M. Fisher, "An Analysis of Switched Access Pricing and the Telecommunications Act of 1996"). According to this theory, a Bell Operating Company within its region will price its interLATA service lower than it would outside the areas where its local exchange affiliate provides access service, and thus will forego revenues in the interLATA market, in order to lower the market price for all suppliers to stimulate additional usage—and, consequently, additional access revenues for itself. Such an incentive for vertically-integrated BOCs to lower prices more than they would if they were not integrated is better characterized as the exercise of competitive profit-maximizing behavior than as predation. In fact, in any market, the firm will take into account the interactions between related submarkets. This price reduction incentive has been pointed to by some as actually being a beneficial aspect of allowing BOCs into the

[31] Oklahoma Corporation Commission Rules, Chapter 55: "Telecommunications Services," OAC 165:55-17-

interLATA market, and not as a detriment to competition.[32] Surely, to the extent that they are not anticompetitive, lower prices are one of the benefits for consumers of increased competition in any market, and the Act contains sufficient safeguards to prevent BOCs from pricing their interLATA service anticompetitively.

34. Moreover, while this non-traditional competition argument identifies a possible theoretical incentive for the BOCs to price lower than they would were these not integrated markets, in practice the strategy only works in certain specified conditions that are unlikely to occur. In order for it to be profitable for a BOC to forego interLATA revenues in exchange for additional access revenues, the BOC must have a relatively low interLATA market share in order to ensure that it is not foregoing too much revenue. However, the BOC's market share must nevertheless be high enough for the BOC to influence the market price in order to stimulate overall demand to generate access revenues. In other words, in order for this strategy to work, the BOC's market share cannot be too low and cannot be too high -- like Goldilocks's porridge, it must be "just right." The likelihood of the BOC knowing what the "just right" market share is, and then manipulating the market in such a way as to achieve that level is not strong, particularly since the "just right" market share for any particular company is a function of the demand elasticity for interLATA service and the relative contribution in that company's switched access prices.

2. Discrimination

35. The Commission has noted as well that "a BOC may have an incentive to discriminate in providing exchange access services and facilities that its affiliate's rivals need to compete in the interLATA telecommunications services and information services markets." See FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶ 11. However, as with the risk of subsidization and misallocation of costs, the Commission has already concluded that its

[32] MacAvoy (1996), p. 179. David S. Sibley and Dennis L. Weisman, "The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," April 1996 (Revised December 1996).

existing rules, again supplemented with additional requirements adopted in compliance with the Act in a 185 page Order, are sufficient to minimize the potential for such discrimination:

> We believe, however, that sufficient mechanisms already exist within the 1996 Act both to deter anticompetitive behavior and to facilitate the detection of potential violations of section 272 requirements. FCC 96-489, First Report and Order, CC Docket No. 96-149, ¶ 321.
>
> We believe that the reporting requirements required by the 1996 Act, those required under state law, and those that may be incorporated into interconnection agreements negotiated in good faith between BOCs and competing carriers will collectively minimize the potential for anticompetitive conduct by the BOC in its interexchange operations. In addition to deterring potential anticompetitive behavior, these information disclosures will also facilitate detection of potential violations of the section 272 requirements. Id., ¶ 327.

36. However, even without the new requirements and prohibitions in the Act, regulators today are certainly capable of preventing BOCs from discriminating in favor of their own affiliates in the provision of exchange access, particularly given the ever-vigilant eyes and ears of the BOCs' competitors who are also always on the lookout for such activity. In fact, some state regulators for years have successfully monitored BOC activity in the intraLATA toll market, where BOCs have competed with IXCs with fewer regulatory safeguards than will be in place in the interLATA toll market.

37. The ability of competing IXCs to use unbundled network elements as an alternative access path to any customer also makes it difficult for BOCs to discriminate. In its recent interconnection decision, the Commission stated, "We confirm our tentative conclusion ... that section 251(c)(3) [of the Act] permits interexchange carriers and all other requesting telecommunications carriers, to purchase unbundled elements for the purpose of offering exchange access services, or for the purpose of providing exchange access services to themselves in order to provide interexchange services to consumers." FCC 96-325, First Report and Order, ¶ 356. Therefore, a carrier competing with SBLD can purchase an unbundled local loop, or other necessary network elements, for exchange access to any of SWBT's current customers for the purpose of providing its own or other carriers' interexchange

services to that customer. A carrier pursuing such a strategy, once it has limited facilities of its own, has few, if any, sunk costs. As already noted above, a number of agreements have already been signed -- and several of these approved by the OCC.

38. It is worth emphasizing again that BOCs have not discriminated in the cellular market where they control an essential input and an affiliate competes against unaffiliated companies. The local exchange carrier in those markets clearly has not favored the BOC's affiliated cellular company, even though they theoretically would have the incentive to do so. If BOCs were favoring their affiliated cellular providers, presumably the BOCs themselves would be reluctant to provide cellular service in other regions where they would be competing against the wireline carrier's affiliate. In fact, BOC cellular companies, including Southwestern Bell Mobile Systems, an affiliate of SBC Communications Inc., aggressively and successfully compete against the wireline affiliate in many regions throughout the U.S.

39. IntraLATA toll is another good example of how regulation since divestiture has ensured that a vertically-integrated firm competes fairly in the retail market. There have been fewer safeguards in the intraLATA toll market than will exist in the interLATA market, yet IXCs have chosen to compete in the intraLATA markets for years. IntraLATA service is not incidental for IXCs—they have had to decide whether or not to compete in that market. When IXCs run through their litany of ways in which BOCs supposedly will be able to discriminate in the interLATA market, all of which would have been available for the BOCs to use even more forcefully in the intraLATA market, it is a wonder that they entered intraLATA markets of their own accord. If IXCs really believed that BOCs are effective at discriminating, surely they would have avoided the intraLATA market.

40. It is often opined by those opposed to BOC interLATA entry that no regulatory safeguards are sufficient to prevent discrimination because the BOCs will be able to subtly cloak discriminatory conduct as legitimate business practices. These opinions assume a considerable degree of gullibility and naiveté on the part of regulators. In my experience, and as one who has advocated an even greater degree of deregulation than has occurred, I believe that regulators generally have a realistic, if not exaggerated, understanding of an integrated

firm's incentives, and are obdurately suspicious about the actions of regulated companies in this regard.

C. Examples of Competition with BOCs Before the Act

41. The actions of IXCs and others in voluntarily competing in the intraLATA and local exchange markets provided hard evidence to convince Congress that it was no longer necessary to maintain an entry barrier keeping BOCs out of the interLATA market during the transition to competition in the local exchange in order to protect competition in the interLATA market. Although local exchange competition is clearly desirable for the beneficial impacts of competition in the local exchange market itself, it also will reduce and then obviate the need to rely on regulation to oversee competition. The advent of local exchange competition will make it even more likely that there will be fair competition in the interLATA market.

42. The Act only requires the *opening* of competition in the local exchange as a prerequisite to BOC interLATA entry. However, the Commission should also take note of the development of *actual* local exchange competition in Oklahoma and throughout the rest of the country as further evidence of the BOCs' inability to engage in discriminatory practices, and thus as support for BOC entry into all telecommunications markets. In Oklahoma, as of the date of this filing, SWBT has ten approved facilities-based interconnection agreements. Indeed, SWBT in its region has been in the vanguard of BOCs in reaching interconnection agreements with potential competitors.

43. The development of actual, facilities-based competition in the local exchange in Oklahoma, in addition to opening the local exchange to competition as required in the Act and as demonstrated by compliance with the checklist, is further evidence that Southwestern Bell will not be able to use its position as a local exchange carrier as an anticompetitive advantage in the interLATA market.[33] In order for a vertically-integrated company to discriminate in the downstream competitive market, other downstream competitors must be unable to avail

[33] A similar conclusion holds for intraLATA toll competition.

themselves of alternative suppliers of essential inputs. The fact that there are competitors in the local exchange market in Oklahoma, coupled with the ability of IXCs to use unbundled network elements as an alternative to SWBT's access, indicates that downstream competitors can avail themselves of alternative suppliers. This fact undermines SWBT's ability to discriminate. I call what Congress has developed for BOC interLATA entry a "belt and suspenders" approach. The Act's regulatory safeguards and entry conditions are the "belt" to hold up fair competition in the interLATA market during the transition to a fully competitive local exchange market, and the actual development of competition is the "suspenders."

VII. CONCLUSION AND SUMMARY

44. At the time of divestiture, it was generally assumed that the local exchange was a natural monopoly, and that only long distance service and CPE could be provided competitively. In order to promote competition in long distance, however, the Justice Department believed that it was necessary to fully separate the local exchange business from the long distance business via a corporate divestiture of AT&T. In addition, it was decided at that time that the Bell Operating Companies, which would maintain the "natural" monopoly in the local exchange, should not be allowed to reintegrate into the long distance market. Almost from the start, the BOCs have argued on efficiency and general competitive grounds for removal of the MFJ's line-of-business restrictions, particularly that which kept them out of the long-distance market. However, it is the opening by state regulators of the local exchange market to competition along with the almost immediate backwards reintegration of the interexchange carriers and others into the intraLATA toll and local exchange market that provides the most compelling argument for allowing the BOCs, including Southwestern Bell, to enter all communications markets, including the interLATA market.

45. The incumbent interexchange carriers, who argue strenuously that the BOCs should not be allowed to compete against them in their "home" interLATA market, began competing against the BOCs soon after divestiture in the intraLATA toll market and are now actively competing even in the local exchange. They clearly believe vertical integration is an important competitive strategy. If, as the now discarded MFJ theory says, the BOCs should not

be allowed to compete in the interLATA market because their market power in the local exchange will give them unfair competitive advantages in the downstream market, why would interexchange carriers have left their protected interLATA market to compete against the BOCs in the BOCs' "home" markets? This point is crucial to an understanding of the economic reasoning underlying why Congress refused to mandate that there be a fully competitive market in the local exchange, as measured by traditional antitrust standards, prior to BOCs being allowed into the interLATA market.

46. Congress has explicitly required only that the *feasibility* of a competitive local exchange market for both residential and business customers be demonstrated prior to allowing BOCs into the interLATA market (through actual interconnection agreements or a state-approved statement of generally available terms and conditions). Congress has allowed the BOCs to participate in the interLATA market during the transition to a fully competitive local exchange market because Congress believes that regulators—state and federal alike—can effectively use their existing tools, *coupled with those in the Act*, to protect competition in the interLATA market, even when the BOCs may still retain some level of market power in the local exchange. And the evidence for the effectiveness of regulatory tools in this respect is the voluntary participation of interexchange carriers and competitive local exchange carriers in the intraLATA toll and local exchange markets, which were opened to competition and protected by state regulators (with fewer safeguards than will exist in the interLATA market under the Act), in some cases right after divestiture. In summary, it makes little sense for the Commission to carefully establish a set of regulatory safeguards against anticompetitive practices, pronounce them sufficient, and not allow the market entry they were designed to allow to occur. The Commission therefore should immediately authorize SBLD to originate interLATA service in Oklahoma, in order to allow open competitive markets to achieve the purposes and goals of the Act for Oklahoma consumers.

47. Southwestern Bell has provided evidence of its compliance with all of the Act's requirements in Oklahoma, making it eligible to originate interLATA traffic in that state. Clearly such entry is in the public interest because the benefits of giving Oklahoma consumers

the ability to choose SBLD for their interLATA service far outweigh the risk that Southwestern Bell will either subsidize its interLATA service or discriminate in favor of it.

KENNETH GORDON

Subscribed and sworn before me this 15th day of January 1998.

Notary Public

My commission expires: _____

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Dr. Kenneth Gordon is a Senior Vice President with National Economic Research Associates, specializing in utility regulation and related issues. He was Chairman of the Massachusetts Department of Public Utilities from January 1993 to October of 1995. He came to the Massachusetts Commission from the Maine Public Utilities Commission, where he also held the office of Chairman from 1988 through the end of 1992. Prior to that, he was an Industry Economist at the Federal Communications Commission's Office of Plans and Policies. Prior to that, he taught at several colleges since 1965, the most recent position having been at Smith College.

Dr. Gordon was an active member of the National Association of Regulatory Utility Commissioners (NARUC) and served as president of that organization in 1992. He was also a member of the Executive Committee, and the Committee on Communications of NARUC. He has served as Chairman of the New England Conference of Public Utilities Commissioners Telecommunications Committee, and is a former Chairman of the Power Planning Committee of the New England Governors' Conference. He currently also serves on several boards and committees. Dr. Gordon has authored a number of publications and lectures widely on topics related to utility regulation.

Dr. Gordon is a graduate of Dartmouth College and holds a doctorate in economics from the University of Chicago.

EDUCATION

University of Chicago	Ph.D	1973
University of Chicago	M.A.	1963
Dartmouth College	A.B.	1960

EMPLOYMENT

November 1995 -	**National Economic Research Associates, Inc.**, Washington, D.C. Senior Vice President
October 1995	**Consulting Economist**
January 1993 - October 1995	**Massachusetts Department of Public Utilities** Chairman
October 1988- December 1992	**Maine Public Utilities Commission** Chairman
1980 - 1988	**Federal Communications Commission, Office of Plans and Policy** Industry Economist
1965 - 1980	**University and College Teaching** (most recently at Smith College)
1963 - 1964	**University of Chicago** Research Associate

CURRENT APPOINTMENTS AND MEMBERSHIPS

Telecommunications Policy Research Conference
Chair, 1995-1996
Board Member, 1994

Energy Modeling Forum (EMF 15. A Competitive Electricity Industry),
Stanford University
Member

American Economic Association

Transportation and Public Utilities Group, AEA

PAST APPOINTMENTS AND MEMBERSHIPS

National Association of Regulatory Utility Commissioners
Communications Committee, 1990 - 1995
Executive Committee, 1991-1995
President, 1992

New England Conference of Public Utility Commissioners
Power Planning Committee
Chairman

Governor's Electric Utility Market Reform Task Force
Co-Chairman

Boston University Telecommunications Forum
Advisor

Center for Public Resources, Legal Program to Develop Alternatives to Litigation
Chairman, Utilities Committee

Office of Technology Assessment, Advisory Panel on International Telecommunications Networks

Bellcore Advisory Committee,
Member and Chairman, 1993 to 1996

ACTIVITIES

Participant in numerous regional and state committees, organizations, and task forces.

Participant in various NARUC/DOE conferences on gas and electricity issues.

Frequent speaker on electric, telephone and environmental issues nationally.

TESTIMONIES

Before the Arizona Corporation Commission, on behalf of Tucson Electric Power Company: testimony regarding the Commission's rules for introducing competition into the electric industry, filed January 9, 1998.

Before the Maine Public Utilities Commission, on behalf of Central Maine Power Company: testimony regarding the Commission's proposed affiliate rules, filed January 2, 1998.

Before the Indiana Utility Regulatory Commission, on behalf of Ameritech Indiana: testimony regarding Ameritech Indiana's proposal for an interim alternative regulation plan, filed November 15, 1997.

Before the Public Utility Commission of Texas, on behalf of Entergy-Gulf States Utilities: rebuttal testimony regarding Entergy's "Transition to Competition" proposal, filed October 24, 1997.

Before the Illinois State Senate, "Report on SB 55," on behalf of Illinois Power Company: report and testimony on proposed electric industry restructuring legislation in Illinois, filed October 9, 1997.

Before the Indiana Utility Regulatory Commission, on behalf of Ameritech Indiana: testimony regarding Ameritech Indiana's proposal for a new alternative regulatory framework, filed July 30, 1997.

Before the Public Utilities Commission of Ohio, on behalf of Ameritech Ohio: testimony responding to AT&T's "Complaint against Ameritech Ohio, Relative to Alleged Unjust, Unreasonable, Discriminatory and Preferential Charges and Practices," filed July 7, 1997.

Before the New Jersey Board of Public Utilities, on behalf of Public Service Electric and Gas Company: testimony regarding transition cost recovery from self generators, filed June 19, 1997.

Before the New Jersey Assembly Policy and Regulatory Oversight Committee, on behalf of Public Service Electric and Gas Company: testimony regarding transition cost recovery from self generators, June 16, 1997.

Before the Kansas Corporation Commission, on behalf of Kansas Pipeline Partnership: testimony regarding Purchase Gas Adjustment proceeding for Western Resources, Inc., filed May 28, 1997.